

Franchise Tax Board**ANALYSIS OF ORIGINAL BILL**

Author: Maldonado Analyst: Victoria Favorito Bill Number: SB 794
Related Bills: See Legislative History Telephone: 845-3825 Amended Date: March 28, 2007
Attorney: Daniel Biedler Sponsor: _____

SUBJECT: Environmental Building Expenses Credit

SUMMARY

This bill would allow a credit for certain environmental building expenses.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to promote the development of environmentally friendly buildings by utilizing the latest green technologies in the planning, renovating, and building process.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately upon enactment and would specifically apply to taxable years beginning on or after January 1, 2008, and before January 1, 2016.

POSITION

Pending.

ANALYSIS**FEDERAL/STATE LAW**

Existing state and federal laws provide various tax credits designed to provide tax relief for taxpayers who incur certain expenses (e.g., child adoption) or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). These credits generally are designed to provide incentives for taxpayers to perform various actions or activities that they may not otherwise undertake.

Board Position:

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Department Director**Date**

Lynette Iwafuchi
for Selvi Stanislaus

5/9/07

Generally, under state and federal law, the cost of erecting a building or other structure or a major improvement or repair to an existing building is considered a capital expense. If the building or structure is used in a trade or business or held to produce income, the costs expended must be capitalized into the cost basis of the property and deducted against income through depreciation over the useful life of the building or structure. If the building is not used in a trade or business or held to produce income (a personal asset), costs expended must still be capitalized into the cost basis of the property. The cost basis of a personal asset is used to determine the amount of taxable gain or loss upon subsequent disposition of the property.

Under current state and federal law, a repair, renovation, or improvement to a building that does not increase the value of the building or extend its useful life is considered a current expense rather than a capital expenditure. If the building is used in a trade or business or held to produce income, the expense is deducted against income in the taxable year in which the expense is paid or incurred. If the building is a personal asset, the costs expended are considered personal expenses of the taxpayer and are non-deductible and cannot be capitalized.

THIS BILL

This bill would allow a credit equal to 5% of environmental building costs paid or incurred to construct, repair, maintain, rehabilitate, or improve a commercial or multifamily residential structure or structures totaling at least 25,000 square feet (sq. ft.). Environmental building costs are defined to mean costs paid for the following items:

- A fuel cell or photovoltaic module that provides electrical power for a structure or structures. A fuel cell is defined as a device that produces electricity from hydrogen or hydrocarbon fuel in a noncombustible electrochemical process. A photovoltaic module must produce electricity from direct sunlight.
- A chiller used in a cooling system for a structure or structures that uses non-ozone depleting refrigerant, which is defined as a refrigerant, used in air conditioning systems, that does not contain chlorine and does not adversely affect the earth's ozone layer.
- Any fixture, including a device, material, or mechanical system, certified by the California Environmental Protection Agency (CalEPA) to be environmentally sound or energy efficient. Environmentally sound means a fixture that has negative impacts on the environment that are less than any other product that is commonly used for the same purpose in a structure. Energy efficient means a fixture that reduces the consumption of heat, process heat, space heating, water heating, steam, space cooling, refrigeration, mechanical energy, or electricity and exceeds applicable energy efficient standards.

This bill would require the CalEPA to complete the certification of fixtures by July 1, 2008, and annually update the list of certifications by each July 1 thereafter. The CalEPA may delegate the certification process to any of its member boards or departments, the California Energy Commission, the Department of Water Resources, or the State Department of Health Services.

This bill would require the CalEPA to submit a written report by January 31, 2015, to each house of the Legislature recommending the retention, extension, or repeal of this section.

This bill would allow up to \$25 million in credits under the Personal Income Tax Law (PITL) and the Corporation Tax Law (CTL), in the aggregate, for environmental building costs in any one calendar year. In the event that more than \$25 million in credits are validly claimed in any one year, the California Tax Credit Allocation Committee (TCAC) would allocate up to \$25 million in credits based on the TCAC's determination of which claimant's environmental building costs incurred would result in the greatest proportionate increases in environmental soundness and energy efficiency. The TCAC would be required to promulgate regulations governing the implementation of the TCAC's duties regarding the allocation of this credit.

This bill would remain in effect until December 1, 2016, and would be repealed as of that date.

This bill would allow any unused credit in excess of the taxpayer's tax liability to be carried over to the following year and succeeding seven years if necessary until the credit is exhausted.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

This bill would require TCAC to allocate the credit after taxpayers file returns claiming the credit and only if the aggregate amount of credits claimed for a calendar year exceeds \$25 million. To determine whether TCAC allocation would be required, the department would have to hold all returns claiming the sustainable building costs credit. The department would be required to pay interest on any refund not mailed to a taxpayer within 45 days of the return's filing date. Additionally, under present law, a taxpayer could file an amended return, up to four years after the original due date of the return, claiming the credit. Generally, allocation or pre-certification of credits is done prior to the filing of tax returns claiming that credit. It would be more efficient for the administration of this credit if TCAC were required to pre-certify or allocate this credit prior to a taxpayer being entitled to claim the credit.

The bill uses terms that are undefined, namely "validly claim," "material," and "structure." The absence of definitions to clarify these terms could lead to disputes with taxpayers and would complicate the administration of this credit.

TECHNICAL CONSIDERATIONS

The bill would allow a credit equal to 5% of "environmental building expenses;" however, in some places the bill defines "environmental building costs." Amendments 1, 2, 3, and 4 would resolve these inconsistencies.

LEGISLATIVE HISTORY

SB 2037 (Alarcon, 1999/2000) would have allowed a credit equal to 5% of environmental building costs paid or incurred to construct, repair, maintain, rehabilitate, or improve a commercial or multifamily residential structure. SB 2037 did not pass out of the Senate Revenue and Taxation Committee.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Florida, Illinois, Massachusetts, Michigan, and Minnesota follow United States Green Building Council's Leadership in Energy and Environmental Design (LEED) Green Building standards (a nationally accepted benchmark for the design, construction, and operation of high performance green buildings). These states do not provide a credit comparable to the credit allowed by this bill.

New York offers a green building credit comparable to the environmental expense credit proposed under this bill. *New York* applies the same green building standards. However, the aggregate amount of credits on each certificate is capped at \$2 million and the applicable percentage is 1.4% (1.6% for a building located in an economic development area).

FISCAL IMPACT

This bill would require a new form or worksheet to be developed for the calculation of the credit. This bill would impact the department's printing, processing, and storage for tax returns. As a result, the department may incur costs necessary to ensure that these forms are available for taxpayers to comply with the reporting requirement.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, the personal income tax and corporation tax revenue loss from this bill would be as follows:

Revenue Analysis for SB 794 – as Amended 03/28/07 Enactment Assumed after June 30, 2007 Effective and Operative January 1, 2008 (\$ in Millions)			
Fiscal Year	2007-08	2008-09	2009-10
Revenue Impact	-\$6	-\$23	-\$24

This analysis does not consider any possible changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

Subject to a \$25 million limit, the revenue impact of this bill would depend upon the number of qualified large new buildings constructed or existing buildings rehabilitated each year, the respective amount of environmental building expenses paid or incurred certified by the CalEPA per project, and the amount of credits that would be applied to reduce tax liabilities.

Industry experts estimate that qualified California construction in 2005 would be \$239 million. It is assumed that:

- Approximately \$26 billion of multi-unit residential construction would be in structures with more than 25,000 sq.ft. That is derived as follows: Total value of multi-unit construction is \$48 billion. Assuming average unit size of 1,277 sq.ft. buildings with 20 units or more would qualify. Census reports that 55% of multi-unit residential buildings have 20+ units (\$48 billion x 55%).
- Approximately \$7 billion of residential improvements would be in large structures. That is derived as a proportionate share of overall residential improvements valued by Census at \$161 billion (\$161 billion x the ratio of qualified residential construction to all residential construction (\$26 billion ÷ \$642 billion)).
- Approximately \$206 billion of nonresidential investment would be in large structures. This is 80% of total nonresidential private construction (\$257 billion).
- Approximately one-third of construction would have energy efficient fixtures.
- For property with energy efficient fixtures, approximately 4% of construction costs would qualify for the credit. This percentage is derived from an October 2003 report to California's Sustainable Building Task Force entitled "The Cost and Benefits of Green Building Design".
- Approximately 17% of the value of U.S. private construction is in California.

Using these parameters, the value of qualified California construction in 2005 would be \$536 million (sum of qualified property x ratio of construction with energy efficient fixtures x ratio of qualified costs to total construction costs x California ratio (((\$26 billion + \$7 billion + \$206 billion) x 33% x 4% x 17%).

Assuming 3% inflation and 2% economic growth, qualified expenditures are grown to 2008 and beyond and multiplied by the 5% credit rate, resulting with \$31 million qualified credits in 2008. Because this is greater than the \$25 million maximum, the credit would be limited to \$25 million.

Taxable year estimates are converted to cash flow fiscal year estimates. The estimate assumes 80% of credits generated are applied in the year generated. Unapplied credits are carried over and applied ratably over the succeeding two years. Amounts shown under fiscal year 2007-08 primarily reflect reductions in 2008 estimated tax payments based on perceived benefits that would accrue to impacted taxpayers under proposed law (i.e., taxpayer awareness). In the case of calendar year taxpayers, the cash flow associated with the first and second payment of estimated 2008 tax liabilities (due in April and June of 2008) occur within the 2007-08 fiscal year.

POLICY CONCERNS

This bill would allow taxpayers in certain circumstances to claim multiple special tax credits for the same item of expense. Accordingly, an expenditure could qualify for the credit proposed by this bill in addition to the Solar Energy Credit, Enterprise Zone sales or use tax credit, or Targeted Tax Area Credit.

In the case of a building used in a trade or business, this bill would not require the basis of the building or the current expense to be reduced by the amount of the credit. Therefore, it would result in a double benefit by allowing a credit and deduction for the same item.

Conflicting tax policies come into play whenever a credit is provided for an expense item for which preferential treatment is already allowed in the form of an expense deduction or depreciation deduction. This new credit would provide a double benefit for these "green" by design and qualified expenses. On the other hand, making an adjustment to reduce the basis or expense in order to eliminate the double benefit creates a state and federal difference, which is contrary to the state's general federal conformity policy. In the case of a one-time expense deduction, the reduction of that expense would not create an ongoing difference between federal and state laws; however, if the expenditure must be capitalized, an ongoing difference would be created.

This bill would allow the credit in the taxable year in which the equipment is purchased, which may be earlier than the taxable year in which the equipment is actually placed in service (i.e., used) in California. Most credits involving the acquisition and subsequent use of an item of property allow the credit to be claimed in the taxable year in which the placed in service date, for depreciation purposes, occurs. It is possible that a taxpayer could purchase the equipment, claim the credit, and resell the equipment to a third party that may also claim the credit. If this bill were to require that the equipment be placed in service in California, with an appropriate recapture provision to ensure continued operation in California for a specified (recapture) period, this potential problem would be avoided. The recapture provision would require the taxpayer to use the equipment for a certain length of time in this state or add all or some portion of the credit amount back to the tax liability.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO SB 794
As Amended March 28, 2007

AMENDMENT 1

On page 3, line 24, strikeout "Environmental building costs" and
insert:

Environmental building expenses

AMENDMENT 2

On page 4, line 35, strikeout "costs" and insert:

expenses

AMENDMENT 3

On page 5, line 23, strikeout "Environmental building costs" and
insert:

Environmental building expenses

AMENDMENT 4

On page 6, line 31, strikeout "costs" and insert:

expenses